



The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: July 2008

An agitated Congress flexed its muscles by challenging the White House on several issues that Members perceived to be in their better interests. A bill to offset proposed cuts in Medicare provider payments was enacted over the objections of the President mere hours after the veto message was received in both chambers of Congress. “Anti-speculator” efforts in both the Senate and House designed to prohibit institutional investors, including public pension funds, from participating in commodity futures markets failed to advance, thanks in large part to efforts by CalPERS. However, even as the debate in this area becomes entangled in the broader dispute over energy policy, the issue of “excessive speculation” continues to be a focus of Congressional concern, and more sophisticated efforts to limit the ability of institutional investors to use this important asset class are likely to continue to be pushed by a Congressional leadership anxious to claim it is acting to address the rising price of gasoline and food. Major housing legislation became law after the President withdrew a veto threat when it became clear that such a veto might also be overridden by Members whose constituents want action on the unsteady housing market.

Issues and Events

Anti-Speculator Efforts Fail – For Now

“Anti-speculator” bills buckled in both the House and Senate, as Republicans pressed to make the legislation a comprehensive energy bill while Democrats, insisting that they had made a good-faith effort to do so, quarreled over the correct manner in which to address the role of institutional investors. The Senate measure (S.3268) failed on procedural grounds, gaining only 50 of the 60 votes needed, on the morning of July 25. The Senate leadership has also been unable to move to a new topic, as the GOP Members held firm and prevented the Senate from ending discussion of the matter. Meanwhile, on the House side of Capitol Hill, legislation that would have banned CalPERS and other institutional investors from commodities, equity futures, interest rate swaps, currency swaps, and other risk management tools was stripped of such provisions – reportedly over the strong objections of House Speaker Nancy Pelosi (D-CA) -- before being reported by the House Agriculture Committee. CalPERS’ statement on commodities investment, entitled “CalPERS Supports Informed Regulation,” reportedly helped carry the day for opponents of such a ban.

The Senate legislation would essentially order futures trading back to the United States from more *laissez faire* markets in London and Dubai by insisting on certain standards of regulation on any trades related to American energy (sweet Texas crude is a benchmark of the market). It establishes a cap on the number of contracts any investor might have, and substantial portions of the bill are intended to divide “legitimate” traders from “nonlegitimate” or “speculative” ones. Legitimate traders are engaged in actual hedging against price increases, while nonlegitimate ones have no intention of taking delivery of the commodity in question. Most of the new restrictions aim at the nonlegitimate traders and the measure

also makes provision to administer these changes by allowing the Commodity Futures Trading Commission (CFTC) to hire more staff.

With many GOP Senators saying they had no problems with the anti-speculation bill and that they would support including its provisions in a larger piece of legislation, GOP speaker after GOP speaker returned to say that S.3268 was about oil scapegoats, not oil supplies. Democrats answered calls to open up the Outer Continental Shelf (OCS) to oil drilling with questions about why the oil industry is not drilling on the tens of millions of acres already leased from the government. Democrats fixed the blame for current prices on speculators, with many basing their conclusions on testimony of oil executives who claimed that the fundamentals suggested that oil should be no more than \$55 a barrel rather than the \$140 currently, with speculation causing the difference.

Behind the scenes negotiation on OCS drilling reportedly collapsed the night of July 23, making its failure to gain the 60 votes needed to proceed under the Senate's cloture rules a certainty. Various charges of bad faith were exchanged.

During the debate, public pension plans were mentioned as an example of what is wrong with the current market. Commodity futures should not be held like "just another stock," but rather used for legitimate hedging. In the run-up to floor action, institutional investors had been fingered as bad guys in the furious futures trading that has driven up the price of gasoline and food for consumers. Senator Joe Lieberman (I-CT) had earlier discussed the possibility of a blanket ban on institutional investors with more than \$500 million in assets from investing in the market, but he decided not to include it in subsequent legislation that he introduced (S.3248); nor did such a provision appear in the bill sent to the Senate floor or as an amendment offered from the floor by Lieberman or like-minded Senators.

The same week, a working group on commodity prices, headed by the Commodity Futures Trading Commission (CFTC) and including the Federal Reserve, Securities and Exchange Commission, and the Treasury Department, released a report on July 23 that found no evidence that speculators were driving up prices. The group contended that investors were instead reacting to price and supply information in a rational manner. According to the group, oil and commodity prices have been pressed higher by fundamental market forces.

Senate Leaders could return to the issue after the summer recess.

In the House, despite reportedly heavy pressure from the House Democratic leadership to ban institutional investing in commodity futures, the Agriculture Committee ultimately decided to delete the section of the Chairman's proposed commodity reform bill containing such a prohibition from the bill as approved by the committee, which has legislative jurisdiction over the CFTC. In the hours leading up to the Agriculture Committee's vote, CalPERS had developed a statement on the issue which shared the concerns expressed by many Members of Congress and other policy makers regarding the increases in commodity prices and their consequences for consumers and for the overall U.S. economy, but also pointed out that there was no empirical evidence of anything other than a circumstantial correlation between commodity index investments and rising commodity prices.

The CalPERS statement, while noting that the CalPERS Board has not endorsed any specific piece of legislation, expressed general support for those provisions of pending legislation in the House and Sen-

ate that were aimed at strengthening the oversight authority of the CFTC, such as increasing the number of CFTC personnel, providing more funding for these increases and insuring the Commission has up-to-date technologies capable of carrying out new and significantly increased regulatory authority. However, the statement also made it clear that CalPERS strongly opposed legislation that would either directly or indirectly prohibit and/or unnecessarily limit sophisticated institutional investors from investing in commodity-based securities. "Federally mandated restriction on our ability to fully exercise our fiduciary responsibility would establish a dangerous precedent impacting countless institutional investors to the detriment of millions of workers, retirees and their beneficiaries, plan sponsors and the overall U.S. economy," the statement concluded.

According to reports by members of the Agriculture Committee, the CalPERS Statement was very well received. Indeed, one of the Committee's members identified the CalPERS statement as the "turning point" in the Committee's deliberations.

Given the strong desire to pass something addressing spiraling gasoline prices before heading home for the month of August, it therefore came as something of a surprise that the full House subsequently failed to pass the stripped-down bill, HR 6604, when it was taken up on July 30. Although a majority of House members supported final passage by a vote of 276 to 151, the measure nevertheless failed because the Democratic leadership brought it to the floor under a special procedure ("Suspension of the Rules") that requires a two-thirds majority vote. This maneuver was used to keep the GOP from offering amendments to open up more offshore areas to oil drilling. As House Minority leader John Boehner proclaimed, "This is no substitute for a real bill on drilling." The bill's fate -- at least for now -- was sealed when President Bush threatened to veto the measure shortly before it came up for a vote.

But the fight over this issue is not over yet, as House leaders promise to bring the bill back up for a vote under regular orders when the House returns in September. Furthermore, institutional investors must keep in mind that the issue of speculation *per se* did not foil the legislation; indeed, many speakers from both sides of the aisle, on both sides of Capitol Hill, say they supported the concept of limiting excessive speculation. The quickness with which many in Congress are willing to view it as their job to determine what investments are allowed, for how much, by whom, and for how long -- and their eagerness to make markets and institutional investors the scapegoats for complex problems they would rather not explain to the electorate -- indicates the ongoing vulnerability of pension funds in public discourse. The concept of banning pension investments in commodity futures is yet another roundabout path to the creation of a Federal "legal list" that has reared its ugly head in other investment areas such as hedge funds. It is unlikely to quickly disappear, particularly in an election year when simple answers to complex problems have special appeal.

Congress Overrides President On Provider Cuts, Medicare Advantage

Within a day of President Bush's veto, both chambers acted to override and enact legislation that delays a 10% cut in Medicare provider reimbursements by cutting payments to Medicare Advantage (MA) plans.

The House went first, confirming their initial favorable vote with an override tally of 383 to 41. The Senate acted a few hours later, delivering a 70 to 26 defeat for the President. While the Medicare measure is only the third time the President's veto has been overruled, the powerful array of interests support-

ing the vote (including seniors and doctors) made the outcome predictable once the gears started meshing. There was little forceful lobbying from the White House to convert the few Senators needed for the President to prevail and, in fact, four additional GOP Senators joined with the majority on this vote than in the previous one on the issue.

Previous attempts at budget-balancing in years past were the original cause of the provider cuts, which have been delayed and offset since nearly the time they were conceived. At issue for the White House was the perceived damage to MA plans, which the GOP in general favors as a competitive factor in Medicare that they believe will ultimately drive down costs.

Housing Bill Expected to Pass Shortly

A compromise allowed the Congress to finally move forward with a housing bill that includes aid for nearly all the main players in the housing market, and President Bush withdrew his veto threat over the \$4 billion in assistance to localities intended to buy up foreclosed properties. It passed the House on a vote of 272-172 on July 23, and subsequently passed the Senate, 72 to 13, in a rare Saturday session before Congress shut down for the month of August.

“No one agrees with everything in the bill, but I don’t think that there’s anything in this bill that makes the people who are for most of it gag,” said House Financial Committee Chairman Barney Frank (D-MA). The Senate followed suit on July 26, where Banking Committee Chairman Chris Dodd (D-CT) said of the bill that, “This legislation won’t perform miracles. But as others have said, it’s a step - and I hope an important step - to putting our nation on the road to economic recovery.”

The President changed his mind on the bill, signing it on July 30. The White House had previously voiced objection to the bill’s provisions granting funds to States and localities to purchase derelict property. Other portions of the bill, including those providing financial assistance, guarantees, and a new regulator for Fannie Mae and Freddie Mac (the goliath Federal constructs that facilitate mortgage financing) won out in the Administration’s thinking on the housing rescue plan. Earlier in the week of Senate consideration, Congressional Budget Office (CBO) Director Peter Orszag noted the uncertainty behind cost projections for the Fannie and Freddie aid. “There is significant uncertainty involved here,” Orszag later said to reporters. “[It] could be zero. It could be \$100 billion.” The bill allows Fannie and Freddie to borrow an unlimited amount of money from the Treasury, subject only to the Federal debt limit that Congress must extend. Negotiations between Frank and the deficit hardliners of the Blue Dog Coalition of moderate Democrats produced an agreement where Blue Dog leader Representative Allen Boyd (D-Fla.) pronounced, “We’ve got complete confidence in what Chairman Frank has done and his ability to protect the taxpayer.”

The legislation allows Fannie and Freddie to insure higher value mortgages to \$625,000 or 115% of median home price; includes tax incentives for first time buyers; modernizes the Federal Housing Administration; and makes other provisions intended to bolster the flagging housing market.

Labor Department Proposes 401(k) Fee Disclosure Rules

On July 22, the Department of Labor (DoL) published its proposed rules for disclosure of 401(k) fees. The initiative comes after Congressional and other investigations revealed that higher fees can have a

serious corrosive effect on retirement savings over the long-term. The DoL hopes the new rules could save more than \$6 billion in fees over 10 years, with that money moving from fees to account balances for participants.

The rules standardize disclosure. Fees must be stated clearly and administrative charges noted in dollar terms, rather than a general description or some other presentation. Accounts will not only have performance data but also benchmarks, and the account's investment options will be listed. The disclosures must also state how to obtain more information or guidance for the account.

"Our proposal is consistent with public consensus that workers need clear and concise information, not dozens of pages of 'legalese,' about the investment options available under their plans, and that they would benefit greatly from having that information in a comparative format," said Labor Secretary Elaine Chao.

Initial reaction has been mainly positive, with the Securities Industry and Financial Markets Association (SIFMA) voicing its initial support. SIFMA Managing Director of Government Affairs said of the release, "The proposed rule provides an excellent starting point to discuss how best to provide useful information to investors without overwhelming them. Plan participants will benefit both from standardizing how the relevant information is presented across investments and the ability to utilize Website-based disclosure. The Department of Labor should be congratulated for their work, and for their close coordination with the Securities and Exchange Commission."

Portman Warns of Trouble for DB Plans

Confirming the strategic concerns held by public pension advocates for decades, former Congressman Rob Portman (R-OH) told a conference on 2008 Plan Designs that DB plans could become a source of revenue for other Federal concerns, including an extension of President Bush's tax cuts set to expire next year. Portman has also served as U.S. Trade Representative, Director of the Office of Management and Budget, and has been showing up on the short list of possible running mates for Senator John McCain (R-AZ). Portman has consistently been among the brightest, most creative, and friendliest of political figures for the retirement community.

Portman said that, despite the continuing dire predictions for retirement, the political sphere continues to ignore the potentially vast disaster ahead. With 63% of Americans more concerned about funding retirement than healthcare, 60% of Baby Boomers saying they are unprepared for retirement, and 75 million workers without employer-based retirement plans, there has still been a lack of new ideas since the Pension Protection Act (PPA) of 2006. Compared to Social Security and healthcare, retirement security has not received much attention from the Presidential candidates.

The coming need for revenue and the diminishing share of people involved in DB plans puts DB plans at risk, Portman said. The coming need to crack down on entitlements creates more fiscal pressure. "Given the revenue that the government currently devotes to retirement, and given the fact that defined contribution plans are now the dominant plans - taking over from the more traditional defined benefit plans - there are some questions that are going to be asked of our system." Portman said that the best defense in the coming period of "questions" is to run a clean ship where transparency and excellence are

rules and not exceptions. Portman advised all the actors in the retirement field – vendors, sponsors, advisors, and participants – to become more involved in public policy.

Related National and Industry News

Health IT Legislation Clears House Subcommittee

The House Committee on Energy and Commerce Subcommittee on Health passed H.R. 6357, also known by the name and tortured acronym of the Protecting Records, Optimizing Treatment, and Easing Communication through Healthcare Technology Act of 2008 or PRO(TECH)T Act.

Old issues remain, with the thorny questions of privacy and encouraging adoption of the new technology continuing to be troublesome. This bill authorizes \$575 for the next 5 years to fund grants for providers to upgrade and places authority for developing standards with the National Coordinator for Health Information Technology (NCHIT), which would also be made permanent in law. Every part of the Federal healthcare infrastructure and operation would start using Electronic Health Records (EHR's) as soon as standards are finalized.

The dicey issues of privacy generally conform with the Health Insurance Portability and Accountability Act (HIPAA) standard established decades ago and extends that standard to those who process health data. Senior Committee member Henry Waxman (D-CA) continues to work to boost penalties for those who mishandle health information.

Committee sources say that the legislation could come to a final vote in the House this fall.

Some Straight Talk, Some Mumbling, on Social Security

The presidential candidates have offered various ideas on bolstering the Social Security System, which will begin to run a shortfall in the coming decade. Since talk on this topic is notoriously treacherous in a political sense, there has also been a shortfall of details on how rescue plans might work.

Senator John McCain (R-AZ) appears the most consistent, (in that almost no detail has been provided) explaining that his plans for Social Security involve “finding consensus” on combating the creaky system's financial woes. In the past, McCain has supported traditional, mainstream conservative solutions including individual accounts, which Democratic critics call “privatization” of Social Security. However, it does not appear that these accounts have become any more popular than in 2005, when the proposal backed by President Bush flopped with the public and Congress, and its prospects in the next Congress would also appear dim. The GOP nominee says he would consider steps such as raising the retirement age or reducing benefits or COLAs, and it is probable that any new Administration of whatever political stripe will have to consider these options as it confronts the demographic and funding challenges of the government-run retirement system.

Maya MacGuineas, a budget expert at the New America Foundation who advised McCain on Social Security in 2000, said of his current proposal: “In terms of details, there is so much to be filled in.”

Damien LaVera, a spokesman for the Democratic National Committee, hit the hot button words by calling the McCain proposal a “repackag[ing of] President Bush's failed and flawed plan to privatize Social Security.”

While raising taxes is not an option on the table for Republicans, Senator Barack Obama (D-IL) has broached this difficult territory in the outlines of his proposal by including an increase in the payroll tax and a potentially dramatic change in how Social Security delivers benefits. Under current law, workers incur payroll tax on only the first \$102,000 of income, meaning that a multi-billionaire pays no more in payroll tax than someone just barely at the cap. Sensitivity to charges of being tax crazy have prompted a seemingly elaborate plan from the Obama campaign that creates a “doughnut hole” where additional payroll tax liability comes only at \$250,000 in income, with those making between \$102,001 and \$224,999 paying payroll taxes capped as if they made only \$102,000. The new tax bracket for high earners would be only 2-4% on the overage, rather than 6% paid by everyone else on the base payroll tax up to the cap, with employers possibly given some share of the new obligation. While this hodge-podge does generate some revenue, experts estimate it brings in less than half of what will be needed to bridge the shortfall expected in the next decade.

A more fundamental shift in the philosophy of Social Security involves taking the additional money from the new obligation on upper incomes and using it to fund the basic benefits on those who make less. Traditionally, higher payroll taxes have resulted in higher benefits to those paying them.

Even this hedged and tentative proposal brought criticism from Democratic consultants who believe the issue should simply be left alone in an election year. The Obama plan fits nicely with a Republican view of that candidate where the solution to every problem is to soak upper wealthier Americans, and GOP number crunchers contend that, all proposals including Social Security taken together, a person earning more than \$250,000 would pay half of everything they earned above that threshold to the government under an Obama Administration.

The campaign consultants are most likely correct in viewing Social Security reform as an issue too explosive for detailed reform plans during a campaign. Innate imbalances in the system mean that dramatic change of some sort will occur, but the coming decade is the more likely period when those imbalances, which will begin to weigh on the Federal balance sheet, will finally produce real reform.

Review Enforcement Division, Says Outgoing SEC Commissioner

Outgoing Commissioner of the Securities and Exchange Commission (SEC) Paul Atkins characterized the agency's enforcement division as unduly obsessed with investigating and prosecuting potential wrong-doing without acceptable due process protections for the suspects. He said the SEC should establish an oversight body to examine whether fines (a principal enforcement tool) actually benefit shareholders, how the division selects its targets for investigation, and what costs are incurred by those being investigated. Atkins, an avowed libertarian, has contended that fines for corporate misbehavior are simply passed through to shareholders.

Another Report Touts Bio-generic Goldmine

The non-partisan Congressional Budget Office (CBO) added its name to the list of researchers contend-

ing that follow-on biologics or “bio-generics” could save vast sums of money for healthcare payers, the largest of which is the Federal government. Bio-generics are generic versions of biologically-derived medicines, as regular generics are copies of chemically-derived medicines.

The CBO estimates that creating a bio-generic approval process could lead to cheaper drugs that will save the Federal government \$6 billion and the nation as a whole \$25 billion over 10 years. These calculations are in line with those produced last year by Avalere Health, which claimed \$3.6 billion in Federal savings over a decade.

Legislation to create an approval process within the Food and Drug Administration (S.1695) has the support of both liberal lion Ted Kennedy (D-MA), Chairman of the Senate Health, Education, Labor, and Pensions (HELP) Committee, and conservative stalwart Mike Enzi (R-WY), Ranking Member of that Committee. Enzi said of the CBO report, “This budget score confirms that our biosimilar therapeutics bill will save Americans billions of dollars in prescription drug costs.” The HELP Committee passed the legislation in June, 2007, but there has not yet been reciprocal action on the House side. “If the leadership of the House is serious about controlling long-term health costs, they will take steps to pass this legislation soon, not wait until the next Congress,” Enzi said.

The Congressional and industry debate on bio-generics has been narrowed to two primary issues. The first deals with the number of years the brand-name manufacturer will be permitted to exclusively market its drug before the new bio-generic can be brought to market. The second issue is referred to as “evergreening”, which is the possibility that the brand-name manufacturers might make changes or improvements to their original products and potentially earn the right to market those modified products exclusively for an additional 12 years.

The House of Representatives is presently considering two bills, HR 5629 by Representative Anna Eshoo (D-CA) which allows for a period of data exclusivity of 14 years, and H. 1038 by Representative Henry Waxman (D-CA), which has not no period of data exclusivity.

The vast sums of money at stake with biologic drugs have complicated attempts to generate appropriate law. Like many drug issues, the controversy involves how to make generics available to a public beset by relentlessly rising healthcare costs while preserving incentives for companies to undertake the expensive and chancy process of developing new treatments. The House does not yet appear to have a clear opinion on the subject.

Fed and SEC Formalize Practices Behind Bear Stearns Sale

Accepting its apparent new role as a protector of the entire financial system’s solvency, the Federal Reserve System reached an agreement with the Securities and Exchange Commission (SEC) for information sharing regarding investment banks. The Fed previously was seen as the regulator and guarantor of commercial banks but its involvement in facilitating the sale of a tottering Bear Stearns (BS) was seen by many in the market as a declaration that investment banks would now also be under the Fed umbrella.

The two agencies signed a memorandum of understanding on information sharing. David Becker, former general counsel at the SEC, said of the arrangement that “It requires consultation between the SEC

and the Fed in areas that the SEC had thought previously were its exclusive business. But the world has changed,” and the agreement “mostly ratifies facts on the ground.”

The agreement also advances, in fact if not in name, a broad regulatory reform plan to modernize the fractured financial system, where redundancy complicates efficiency and innovation. While the broad plan has no chance of enactment, the Fed-SEC deal makes the first move on one of the plan’s recommendations to have a single regulator oversee solvency for every actor in the market. It appears that the Fed has taken the initial step in becoming that regulator by adding investment banks to its portfolio.